



Arizona Utility
Investors Association

2100 N. Central, Ste. 210
P.O. Box 34805
Phoenix, AZ 85067

Tel: (602) 257-9200
Fax: (602) 254-4300

Email: info@auia.org
Web Site: www.auia.org

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BEFORE THE ARIZONA CORPORATIC

Marc Spitzer
Chairman
William A. Mundell
Commissioner
Mike Gleason
Commissioner
Jeff Hatch-Miller
Commissioner
Kristin Mayes
Commissioner

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IN THE MATTER OF THE APPLICATION OF
ARIZONA PUBLIC SERVICE COMPANY FOR
A HEARING TO DETERMINE THE FAIR
VALUE OF THE UTILITY PROPERTY FOR
RATEMAKING PURPOSES, TO FIX A JUST
AND REASONABLE RATE OF RETURN
THEREON, TO APPROVE RATE SCHEDULES
DESIGNED TO DEVELOP SUCH RETURN,
AND FOR APPROVAL OF PURCHASED
POWER CONTRACT.

DOCKET NO.
E-01345A-03-0437

Arizona Corporation Commission
DOCKETED

SEP 27 2004

NOTICE OF FILING TESTIMONY

DOCKETED BY

Pursuant to the amended procedural order in this matter
dated August 20, 2004, the ARIZONA UTILITY INVESTORS
ASSOCIATION (AUIA) hereby submits the initial testimony of
Walter W. Meek.

Respectfully submitted, this 27th day of September, 2004.

Walter W. Meek, President

CERTIFICATE OF SERVICE

An original and 13 copies of the referenced testimony
filed this 27th day of September, 2004, with:

Docket Control
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Copies of the referenced testimony
hand delivered this 27th day of September, 2004, to:

Mark Spitzer, Chairman
Philip Dion, Executive Assistant
William A. Mundell, Commissioner
Adam Stafford, Executive Assistant
Jeff Hatch-Miller, Commissioner
Dean Miller, Executive Assistant
Mike Gleason, Commissioner
Jodi Jerich, Executive Assistant
Kristin Mayes, Commissioner
Garry D. Hays, Executive Assistant
Christopher Kempley, Esq., Legal Division
Lyn Farmer, Esq., Hearing Division
Ernest Johnson, Esq., Utilities Division

A copy of the referenced testimony was
mailed this 27th day of September, 2004, to:

Thomas L. Mumaw, Esq.
Pinnacle West Capital Corporation
P.O. Box 52132
Phoenix, AZ 85072-2132

Jeffrey B. Guldner, Esq.
Snell & Wilmer
One Arizona Center
400 E. Van Buren Street
Phoenix, AZ 85004-2202

Parties of Record



WALTER W. MEEK

DOCKET NO. E-01345A-03-0437

SETTLEMENT TESTIMONY OF WALTER W. MEEK

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1 **SETTLEMENT TESTIMONY OF WALTER W. MEEK**

2

3 **I. Introduction, Qualifications & Purpose of Testimony**

4 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

5 A. My name is Walter W. Meek. My business address is 2100 North Central
6 Avenue, Suite 210, Phoenix, Arizona 85004.

7 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

8 A. I am the president of the Arizona Utility Investors Association ("AUIA"), a
9 non-profit organization formed to represent the interests of equity owners
10 and bondholders who are invested in utility companies that are based in or
11 do business in the State of Arizona.

12 **Q. DOES AUIA'S MEMBERSHIP INCLUDE SHAREHOLDERS WHO HAVE**
13 **EQUITY INTERESTS IN ARIZONA PUBLIC SERVICE COMPANY (APS)?**

14 A. Yes. APS is a wholly owned subsidiary of Pinnacle West Capital Corporation
15 (PWCC). AUIA's largest membership block consists of common stockholders
16 in PWCC.

17 **Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS PROCEEDING?**

18 A. On behalf of AUIA, an intervenor in this proceeding.

19 **Q. WOULD YOU DESCRIBE YOUR PREVIOUS EXPERIENCE IN**
20 **REGULATORY MATTERS AT THIS COMMISSION?**

21 A. I represent the largest cross-section of utility stockholders in the State of
22 Arizona and I have been involved with the utility business in Arizona for 28
23 years. I have participated in dozens of Commission dockets on behalf of
24 AUIA and testified in numerous proceedings. My testimony has covered
25 topics including rate of return issues, stranded costs, disposition of regulatory

assets, AFUDC, inclusion of CWIP in rate base and the impact of regulatory decisions on analyst and investor expectations.

Q. DO YOU TESTIFY AS AN EXPERT WITNESS?

A. Not really. I will attempt to bring a "real world" investor perspective to some of the financial and regulatory issues raised in the rate case.

Q. HAVE YOU FILED TESTIMONY PREVIOUSLY IN THIS DOCKET?

A. Yes. AUIA filed rebuttal testimony on March 30, 2004.

Q. ARE YOU WITHDRAWING THAT TESTIMONY?

A. No. I am unsure of the appropriate procedure, but AUIA requests that its rebuttal testimony be made part of the permanent record in this case.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY TODAY?

A. I am testifying in support of the proposed settlement agreement in the APS rate proceeding.

Q. IS AUIA A SIGNATORY TO THE SETTLEMENT AGREEMENT?

A. Yes. I have signed the agreement on behalf of AUIA.

II. Reasons for Supporting the Settlement

Q. IN GENERAL, WHY DOES AUIA SUPPORT THE SETTLEMENT?

A. I think there are three main reasons. First and foremost, the proposed settlement resolves some issues that are of grave concern to the financial community. Resolution of those issues signals to financial analysts and rating agencies that APS has a road map and a set of ground rules for conducting its business in future years. Conversely, if these issues aren't resolved equitably, the financial community may conclude that APS faces an unacceptable level of regulatory and financial risk going forward.

Q. WHAT ARE THE KEY ISSUES?

1 A. I will discuss them in greater detail further on, but the key issues are: 1) a
2 revenue stream that provides an opportunity for the company to earn a
3 reasonable return on its asset base; 2) inclusion in rate base of its separated
4 generating units that are now owned by Pinnacle West Energy Corporation
5 (PWEC); 3) adoption of a purchased power and fuel adjustment mechanism
6 that would shield the company and its customers from fluctuating gas prices;
7 and 4) clarification of the means by which APS can meet the growing power
8 supply needs of its customers.

9 **Q. WHAT IS YOUR SECOND REASON FOR SUPPORTING THE**
10 **SETTLEMENT?**

11 A. Because it is fair to ratepayers, shareholders and all of the 22 stakeholders
12 who have signed the settlement agreement. In the five months of
13 negotiations that produced this agreement, every participant experienced
14 both gains and losses compared to its initial litigation position. As a result of
15 this give and take, the interests of all stakeholders are fairly balanced in the
16 agreement. As a further result, the agreement is also very intricate and could
17 come apart if provisions that are important to various parties are altered
18 significantly.

19 **Q. IS THAT A SUGGESTION THAT THE COMMISSION SHOULD**
20 **RUBBER-STAMP THE AGREEMENT?**

21 A. Absolutely not. The Commission should examine the proposed settlement
22 very carefully. When it does, I believe it will find that the broad interests of
23 its constituencies are well served by the agreement. There are times,
24 however, when the Commission seems beset by the need to put its stamp on
25 ordering documents. It's human nature at work and I am only suggesting

1 that the Commission exercise extraordinary caution in this instance.

2 **Q. YOUR THIRD REASON FOR SUPPORTING THE SETTLEMENT?**

3 **A.** Because it would avoid extensive litigation on two fronts, the first being the
4 completion of the rate case. I'm not talking about merely avoiding some
5 inconvenience or even the appalling cost of a fully litigated case. Given the
6 number and breadth of issues in this proceeding, it could take many months
7 to complete. We have nearly 30 parties and the first two rounds of testimony
8 produced more than 40 witnesses. I believe we could spend three months
9 hearing this case and another four to five months arriving at a final
10 Commission decision in mid-2005. During that time, the financial community
11 surely would penalize the company for continued delays and uncertainty.

12 **Q. WHAT IS THE SECOND LITIGATION FRONT?**

13 **A.** Under the terms of this agreement, APS will dismiss all of its appeals and
14 litigation arising from the Commission's Track A decision (No. 65154) and
15 the 1999 settlement agreement (No. 61973). Likewise, the Commission will
16 terminate the Preliminary Inquiry ordered in the APS financing decision (No.
17 65796). It should be recalled that APS and Commission Staff some time ago
18 sidestepped a legal showdown over the APS litigation by agreeing in a
19 Statement of Principles to include the underlying issues in this rate case.
20 Without a negotiated settlement, it is hard to envision a rate case result that
21 would absolve APS from its fiduciary responsibility to seek redress on some
22 issues, including a breach of contract claim against the Commission. In that
23 circumstance, both the company and the Commission would be sentenced to
24 lingering uncertainty and lack of direction.

25 As AUIA noted in its rebuttal testimony, the Commission is also

1 confronted by an Arizona Court of Appeals decision that invalidated major
2 sections of the Commission's retail competition rules. Absent a reversal on
3 appeal, the Commission, at some point, will have to revisit the rules. A
4 continuation of the APS litigation would complicate these issues further.

5 **Q. FROM AN INVESTOR'S VIEWPOINT, IS THERE AN OVERRIDING**
6 **BENEFIT TO THE PROPOSED SETTLEMENT?**

7 A. AUIA is not fixated on the revenue or rate of return components of the
8 agreement, although they are important elements. For perspective, let me
9 note that the financial community reacted in horror to the Staff's direct case in
10 large part because they viewed Staff's position as extreme and thought it
11 signaled a dysfunctional relationship between APS and the Commission. In
12 my view, an overriding benefit of the proposed settlement is that it portends
13 a more rational and stable regulatory environment and a new climate of
14 certainty for APS.

15 **III. Key Issues Resolved By the Settlement Agreement**

16 **Q. YOU CITED FOUR KEY ISSUES THAT ARE RESOLVED IN THE**
17 **SETTLEMENT AGREEMENT. CAN YOU ELABORATE ON THEM?**

18 A. Yes. I will discuss each of them separately.

19 **Revenue Increase and Rate of Return (ROE)**

20 **Q. WHAT DOES THE AGREEMENT PROVIDE WITH REGARD TO**
21 **INCREASED REVENUES AND RETURN ON EQUITY?**

22 A. The settlement agreement calls for an overall increase of \$75.5 million above
23 test year revenues, a nominal increase of 4.2 percent. In fact, that amount
24 includes \$9 million for demand side management, which does not contribute
25 to net operating income, so the real increase is \$66.5 million, an improvement

1 of 3.7 percent over test year revenue. The agreement also provides for a rate
2 of return on common equity (ROE) of 10.25 percent.

3 **Q. HOW WOULD YOU CHARACTERIZE THE ROE PROVISION?**

4 A. It represents a classic compromise, since it is exactly midway between the
5 company's request of 11.5 percent and the Staff's initial recommendation of 9
6 percent. However, it is at the low end of returns that have been authorized in
7 other jurisdictions in 2004, which have ranged as high as 12 percent and have
8 averaged about 10.6 percent. I think the financial markets will view it as
9 anemic but acceptable.

10 **Q. HOW WOULD YOU CHARACTERIZE THE RECOMMENDED REVENUE**
11 **INCREASE?**

12 A. Again, the result is a product of negotiation and is linked to other issues,
13 including the rate-basing of the PWEC units, the APS self-build moratorium
14 and the company's future competitive acquisition of power supplies.

15 On a cash basis, the revenue increase is more than \$100 million less
16 than the company requested. However, the resulting revenue stream and its
17 earnings potential should allow Pinnacle West to continue its progressive
18 dividend policy and that is very important to investors.

19 Beyond that, the best measure of the revenue requirement is the
20 reaction of the financial analysts and rating agencies, which influence the
21 company's ability to access the capital markets on reasonable terms.

22 **Q. HAS THE FINANCIAL COMMUNITY REACTED TO THE PROPOSED**
23 **SETTLEMENT?**

24 A. Yes. Both the securities analysts and the rating agencies have responded in
25 their own ways. I would characterize the response as a mixed bag.

1 On one hand, the analysts view the resolution of the major issues
2 covered by the settlement agreement as a positive development, indicative of
3 an improved regulatory environment for APS. The key issues they cited
4 included rate-basing the PWEC units and adopting a fuel and purchased
5 power adjustment mechanism (PSA). On the other hand, many analysts were
6 disappointed with the amount of the revenue increase and its contribution to
7 projected earnings.

8 Some analysts expressed concern that earnings imputed from the
9 settlement agreement are somewhat dependent on accounting treatments,
10 such as depreciation lives, rather than cash generation.

11 Here are some representative responses from securities analysts, all
12 dated August 19, 2004:

13 • **Lehman Brothers** asserted that "the proposed settlement is a
14 favorable outcome for the company (especially considering staff original
15 testimony), [but] we would have preferred more cash increases as opposed to
16 depreciation life adjustments which give up cash."

17 • **Morgan Stanley** said the settlement represents "a supportive
18 regulatory action for PNW. But in such a fast growth territory, PNW needs
19 [a] regulatory regime that will allow timely recovery of infrastructure
20 investments."

21 • **Merrill Lynch** opined that increased regulatory certainty and the
22 Company's customer growth could merit a premium in its stock rating, "but
23 the rate case settlement initially looks to have fallen somewhat short in terms
24 of earnings power."

25 All of the eight analyst reports I have reviewed since the settlement

1 agreement was announced have adopted a neutral or hold position on
2 Pinnacle West stock. None has made a buy recommendation. That could
3 change for the better if the settlement agreement is approved largely intact. I
4 think the prevailing mood in the investment community is cautious
5 optimism.

6 The credit rating agencies seem to be in about the same place. All
7 three -- Standard & Poor's (S&P), Moody's Investors Service and Fitch
8 Investment Ratings -- have maintained negative outlooks on APS.

9 In an August 20 report, S&P said the settlement agreement was
10 "constructive from a business risk perspective," but added that it would do
11 "little to strengthen the utility's financial profile." S&P also asserted that the
12 proposed rate increase "will not likely inject sufficient incremental revenue
13 into the company to shore up a financial condition that is somewhat
14 pressured at the current rating level."

15 S&P also pointed to the rate-basing of 1,790 MW of PWEC generation
16 and the adoption of a fuel and purchased power adjustment mechanism as
17 significant positive developments.

18 In the final analysis, the challenge with the rating agencies is to
19 maintain APS' investment grade credit rating. The company has computed
20 debt-to-capital and debt coverage ratios resulting from the proposed
21 settlement that appear to support its current BBB rating.

22 **Q. HAS THE SETTLEMENT AGREEMENT HAD AN IMPACT ON THE**
23 **PRICE OF PINNACLE WEST STOCK?**

24 **A.** In the first two days after the agreement was announced, the stock lost about
25 3 percent of its market value. That appeared to be a market reaction to the

1 terms of the agreement. If so, I believe it was primarily a selling response
2 from some funds that were expecting, or hoping for, a revenue increase that
3 was closer to the company's original request and that supported its earnings
4 guidance of the past several months.

5 **Q. HOW WOULD THE FINANCIAL COMMUNITY REACT IF THE**
6 **SETTLEMENT AGREEMENT WERE REJECTED BY THE COMMISSION?**

7 **A.** As AUIA said in its rebuttal testimony, the entire financial community has
8 been holding its breath on Pinnacle West, awaiting a favorable outcome in the
9 rate case. Their reviews of the settlement agreement are somewhat mixed,
10 but I think there is no doubt that the financial community would react very
11 negatively if the Commission rejected the settlement or altered it in ways that
12 would reduce the company's earning potential or degrade its credit metrics.

13 **Rate-basing the PWEC Units**

14 **Q. WHAT DOES THE AGREEMENT PROVIDE WITH RESPECT TO THE**
15 **PWEC GENERATING UNITS?**

16 **A.** It provides that the five PWEC units, totaling 1,790 MW of generation, will be
17 added to APS' rate base at their December 31, 2004 book value, less a discount
18 of \$148 million to account for the remaining value of the Track B contract
19 between APS and PWEC. The net rate base amount is \$700 million.

20 **Q. IS THIS PROVISION CRUCIAL TO THE OVERAL AGREEMENT?**

21 **A.** AUIA believes that it is.

22 I should point out that the rate-basing provision is inextricably linked
23 to the revenue requirement, the 10-year, self-build moratorium imposed on
24 APS and the requirements for APS to purchase power in the competitive
25 market, including 1,000 MW through an RFP process in 2005. If any of these

1 provisions were eliminated or altered significantly, it would affect the
2 interests of several parties to the agreement.

3 In addition, every securities analyst and rating agency that has
4 commented on the proposed settlement has cited the PWEC rate-basing as
5 one of the two most significant issues covered by the agreement.

6 In today's post-Enron environment, the consensus view in the financial
7 community is that any significant exposure to merchant generation by a
8 regulated utility or its parent company is probably detrimental to its financial
9 profile and its credit standing. The financial community is anxious to see this
10 albatross removed from Pinnacle West/ APS.

11 **The Power Supply Adjustor (PSA)**

12 **Q. YOU CITED THE PSA AS A KEY ISSUE. WHAT DOES THE**
13 **SETTLEMENT AGREEMENT CALL FOR REGARDING A PSA?**

14 **A.** Without getting mired in detail, the settlement agreement provides that APS
15 shall implement a PSA that covers both fuel and purchased power and also
16 captures the proceeds from market trading. The change in the adjustor is
17 confined to a limited bandwidth. It will be reset annually and there is a
18 mechanism for sharing savings with ratepayers.

19 **Q. WHAT IS THE SIGNIFICANCE OF THE PSA?**

20 **A.** APS has not had a PSA for a number of years, presumably because its fuel
21 costs stabilized under long-term coal and uranium contracts. Recently,
22 however, conditions have changed in two significant respects.

23 First, APS has developed much more exposure to natural gas as a
24 generation fuel than it had a few years ago, whether as a result of its own
25 decisions to build or as a consequence of its increased reliance on the

1 wholesale market. The bottom line is that there is nothing out there to meet
2 incremental needs economically other than gas-fueled generation.

3 Second, the price of natural gas has risen dramatically in recent
4 months -- more than double since 2001 -- and there is no indication that it is
5 going anywhere but up.

6 Absent a PSA, the company's increased reliance on natural gas puts its
7 cash flows, its earning potential and its credit metrics at risk. That is why
8 virtually every securities and credit rating analyst has rated the PSA as one of
9 the most important provisions in the settlement agreement.

10 **Q. IS THE PSA PROVISION CRUCIAL TO THE SETTLEMENT**
11 **AGREEMENT?**

12 **A.** It is crucial in the sense that it is a major component of the agreement and it is
13 also a critical element in APS' ability to maintain financial integrity going
14 forward. As we noted earlier, the PSA is significant in the investment
15 community's evaluation of the company.

16 **Clarification of APS' Obligation to Serve**

17 **Q. HOW DOES THE SETTLEMENT AGREEMENT CLARIFY APS'**
18 **OBLIGATIONS?**

19 **A.** My response will be more complicated than the question, but the relevant
20 portions of the agreement are Sections IX and X.

21 Section X affirms that APS has the continuing obligation to plan for
22 and serve all electric customers in its service area. However, APS is not
23 granted a right to serve that would exclude other lawful providers and its
24 planning must account for the potential impact of direct access programs.

25 This section also clarifies that APS has the ability to meet its

1 obligations by self-building or buying new generation assets to serve native
2 load, subject to the conditions of Section IX.

3 Section IX imposes a 10-year moratorium on the self-build option, with
4 certain exceptions, and requires APS to conduct a competitive procurement
5 by the end of 2005 for at least 1,000 MW of long-term resources. Under the
6 terms of this section, APS is not precluded from negotiating bilateral
7 agreements for generation resources with non-affiliated suppliers.

8 While some provisions of Section IX may seem to encase APS in an
9 operational straitjacket, the section as a whole has been carefully crafted to
10 give APS and the Commission the flexibility to reach the resource decisions
11 that are in the best interest of APS' customers.

12 **Q. WHAT IS SIGNIFICANT ABOUT THIS CLARIFICATION?**

13 A. As I noted earlier in my testimony, the language of the Track A and Track B
14 decisions has shrouded in uncertainty the options which APS may pursue in
15 meeting its obligation to serve. Without some clarification, APS faces both
16 regulatory and financial risk for its resource decisions.

17 The relevant provisions of the settlement agreement clarify the options
18 that are available to APS and lay out the ground rules that APS must follow
19 in pursuing them. In some instances, APS has the burden of justifying a
20 preferred course of action, but in the final analysis, both APS and the
21 Commission retain the ultimate flexibility to determine which resource
22 decisions are appropriate.

23 **Q. ARE THESE PROVISIONS CRITICAL TO THE SETTLEMENT**
24 **AGREEMENT?**

25 A. The provisions of Sections IX and X are the result of hard-fought negotiations

1 and they are linked directly to the PWEC rate-basing provisions. Elimination
2 or significant alteration of these sections would affect the interests of
3 numerous parties. Therefore, I would argue that they are critical to the
4 settlement agreement.

5 **IV. Conclusion & Recommendation**

6 **Q. WHAT IS AUIA'S RECOMMENDATION TO THE COMMISSION**
7 **REGARDING THE SETTLEMENT AGREEMENT?**

8 A. This settlement agreement is absolutely unique. Twenty-eight parties were
9 involved in the settlement discussions. Twenty-two have signed the
10 agreement and five of the remaining six don't oppose it. Before the
11 negotiations occurred, I could not have imagined that an agreement
12 involving so many parties representing such diverse interests could actually
13 resolve such a plethora of complex and contentious issues. For that reason
14 alone, I believe the Commission should treat this agreement with respect.

15 If it is adopted without significant changes, this agreement will allow
16 APS and the Commission to get on with business and shed the legacy of 1999
17 without further rancorous litigation at this Commission or in the courts. As I
18 noted earlier, the financial community is collectively holding its breath,
19 waiting for an outcome to this case. This agreement will cause them to
20 exhale.

21 Conversely, if the agreement is rejected or dismembered, it will be
22 perceived that APS is rowing upstream against regulatory uncertainty and
23 financial insecurity and the financial community can be expected to react very
24 negatively.

25 Nobody likes everything about this agreement, but AUIA believes that

1 a careful examination of the proposed settlement will convince the
2 Commissioners that the Commission itself and nearly all of the interests that
3 are arrayed before it in this proceeding are well served by it. Therefore,
4 AUIA urges the Commission to approve the settlement agreement without
5 altering its material terms and conditions.

6 **Q. DOES THAT CONCLUDE YOUR TESTIMONY?**

7 **A.** Yes it does.